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March 1, 2000

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VIA HAND DELIVERY

Surface Transportation Board
Office of the Secretary
Case Control Unit
Attn: STB Ex Parte No. 582
1925 K Street, N.W.
Washington, D.C. 20423-0001

RE: *Public Views on Major Rail Consolidations*
STB Ex Parte No. 582

Dear Secretary Williams:

Enclosed herewith are an original and eleven (11) copies of the Written Statement of Michael R. Haverty, President and Chief Executive Officer, The Kansas City Southern Railway Company, for submission in the above-captioned proceeding. A 3.5-inch diskette containing a copy of this letter and Mr. Haverty's statement is also enclosed.

Due to an oversight on our part, the document which we filed with the Board yesterday contained typographical and grammatical errors, which have been corrected in this version. Therefore, please substitute this version of Mr. Haverty's testimony for that filed yesterday.

Please acknowledge receipt and filing of the enclosed statement by file-stamping the enclosed eleventh copy of the statement and returning that copy to the person making that filing for return to

Very truly yours,

William A. Mullins
Attorney for The Kansas City Southern Railway Company

Enclosure
cc: Michael R. Haverty

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BEFORE THE
SURFACE TRANSPORTATION BOARD

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Ex Parte No. 582

PUBLIC VIEWS ON
MAJOR RAIL CONSOLIDATIONS

WRITTEN STATEMENT OF MICHAEL R. HAVERTY
PRESIDENT, CHIEF EXECUTIVE OFFICER
THE KANSAS CITY SOUTHERN RAILWAY COMPANY

February 29, 2000

BEFORE THE
SURFACE TRANSPORTATION BOARD

Ex Parte No. 582

PUBLIC VIEWS ON
MAJOR RAIL CONSOLIDATIONS

WRITTEN STATEMENT OF MICHAEL R. HAVERTY
PRESIDENT, CHIEF EXECUTIVE OFFICER
THE KANSAS CITY SOUTHERN RAILWAY COMPANY

Madam Chairman, Vice Chairman Burkes and Commissioner Clyburn, I wish to thank you for this opportunity to address you about an issue that has taken on ever increasing importance for rail transportation over the past number of years. Your decision to initiate this Ex Parte investigation into the effects of major rail consolidations on the future and, indeed, the very survival of thc railroad industry is to be commended. Today, North American railroading stands at a watershed, and your actions in this proceeding will have lasting impacts for many years to come.

I believe that KCS offers a truly unique perspective on the issues to be addressed in this proceeding. As a Class I carrier, our interests coincide generally with those of the nation's largest railroads. Our access to and substantial investment in Mexico's primary railroads, coupled with our Alliance Agreement with Canadian National, gives us a unique and very practical international perspective on U.S. railroads. On the other hand, we are the smallest Class I carrier, and we interline over 80% of our traffic with the large Class I railroads. As often as not, we share the frustrations experienced by shippers and shortline railroads in dealing with these large entities. In short, KCS has the perspective of both a Class I and regional railroad but also a carrier with real international experience. With that thought in mind I offer the following comments.

My statement today is not the first time I have expressed concern over the movement toward increasing concentration in the railroad industry, and, in my opinion, its likely by-product, re-regulation of the industry. In June of 1996, I was interviewed by the *Journal of Commerce.* In that interview, I identified a sort of "domino" effect, in which one merger has led to another which has necessitated a third, for which a fourth was justified, and so on. I was speaking to the likely effects of the UP/SP merger and I expressed the view that the consummation of the UP/SP merger would result in only two rail competitors in most of the territory west of the Mississippi River and the precedent would inevitably lead to only two major railroad companies in the United States which, in turn, would likely lead to the re-regulation of the railroad industry.

UP/SP was approved and consummated and today UP and BNSF do dominate the west. Those mergers were followed by the split-up of Conrail by Norfolk Southern and CSX. Most recently, the Canadian National merged with the Illinois Central. Now we have the proposed combination of Canadian National and Burlington Northern Santa Fe. Clearly there has been an inexorable flow toward further concentration among railroads with continuous movement towards the ultimate end game; two railroads in North America.

For the first time, we find other major railroads expressing serious concern. However, even now, those railroads, UP, NS, CSX, and Canadian Pacific, do not take the position that ever-increasing concentration is dangerous or that it will lead to the unfortunate consequences of re-regulation. What those railroads are saying, with great effort and at considerable expense, is that now is not the time for another merger. They are saying that the current North American rail network is too weak to respond at this time with more mergers without harming shippers and shareholders. They say this brings into question whether or not the proposed BN/CN merger is in the public interest. With due respect for these viewpoints, my impression is that debates about timing are primarily designed to let the remaining Class I carriers prepare to join in the next round of mergers.

KCS does believe that the BN/CN merger will cause responsive mergers by parties who should be more focused on getting their own houses in order. However, focusing the debate on the timing of the BN/CN merger serves only to distract from the real issues facing the railroad industry, as a result of the proposed merger, namely:

- Whether one railroad merger would necessitate one or more responsive mergers;
- Whether even larger merged railroads will be able to maintain and improve customer service and responsiveness, as they have promised;
- Whether the rail industry is in danger of becoming so concentrated as to threaten the well being of the railroads, their customers, and employees, and lead to the re-regulation of the industry.
- Whether ultimate reduction from 3 to 2 carriers in some corridors would likely increase rail rates in these corridors; and
- Whether further consolidations are in the public interest.

What does history tell us regarding the reactive character of rail mergers? Simply that growth through mergers has been matched with corresponding growth through more mergers. Witness the Eastern railroads' mad scramble for merger partners in the 1960's, culminating in the disastrous Penn Central affair. In the West, BN's acquisition of the Frisco was quickly countered by the UP/MP/WP merger. Shortly thereafter, the East saw the creation of the new

CSX mega-system countered by the creation of the NS system. Back in the West, UP justified its control of CNW as a counter to the Rio Grande/SP combination. UP has publicly stated that its merger with SP was a direct response to the BN-ATSF merger. Finally, we must not forget that the split-up of Conrail between NS and CSX was, in essence, a compromise reached because neither one wanted the other to acquire the whole of Conrail, and thereby be facing a much larger competitor.

The lesson to be learned from this history is that railroads will not let their competitors become measurably larger than themselves without obtaining equalization through their own responsive combinations. Such reactive behavior is seen as logically consistent with the natural inclination of a competitor to maintain competitive parity, while striving for a competitive edge. Maintenance of comparable size is thought to be required because of the leverage provided on issues such as rate divisions, and to replace gateways as friendly connections are swallowed up in other mergers. And, lest there be any doubt about the continued validity of this theory, UP, NS, CSX and CP all have indicated, in one way or another, that approval of the BN/CN combination will, of necessity, require some competitive response, whether it be merger or a more commercially modest alliance agreement.

We need to be very concerned with the continuation of this cycle of major rail mergers that can only result in increased concentration. The Board has traditionally held that two railroads are sufficient to preserve competitive options for shippers. The logical end point of that policy is two major rail systems in North America. What will that mean for the shippers and the economy of this country? That is the ultimate question.

If one looks to the past in order to gain some guidance for the future, I think the jury is still out as to whether shippers as a whole have benefitted from the last twenty years of mergers. I also think the jury is still out on whether shareholders have benefited. They certainly did during the 80's and the early years of the 90's as the railroads benefited from less government regulation, but the latest round of mergers beginning in 1995 have not produced the savings, revenue enhancements and improved customer service that had been promised, thus depressing stock prices.

I can say with complete confidence, however, that the creation of two transcontinental rail carriers would raise a host of concerns. We need to be concerned whether only two major rail systems would so dominate short line and regional railroads as to thwart the influence those smaller carriers currently have on rail prices and services. We need to be concerned whether railroads can become just too big, where they suffer diseconomies of scale because the "machine" is beyond the capabilities of its operators. We need to be concerned that the interests of individual shippers would be sacrificed in the bargaining that could dominate the relationship of two mega-carriers. Finally, we need to be concerned whether two major railroads would be perceived as so destructive to competition and the needs of rail customers that the railroad industry would have to be re-regulated. I raise these issues not as scare tactics or to stir up opposition to future rail mergers, as some might suggest, but rather as an admonition of the damage which can be caused if we do not understand the lessons of history.

We all have worked for and experienced the benefits of deregulation of the industry. I believe that deregulation has resulted in financially stronger railroads while affording improved rail transportation for the shipping public. Re-regulation would be disastrous for the rail shippers of North America and the North American economy, as well as the railroads themselves.

You will undoubtedly also hear today from several persons who believe that re-regulation is a panacea for all of the ills of the railroad industry, real and imagined. Such suggestions are unfortunately both short-sighted and ill-informed. A railroad, the only large-scale form of commercial transportation which must do without significant government assistance to maintain its right-of-way, must be allowed to support its enormous capital investment with market-based rates and responsive customer service. While shippers have legitimate issues with the current state of rail performance, those issues can undoubtedly be resolved within the existing regulatory framework. While I in no way intend to detract from shipper complaints, I think that the reduced rates and improved service which are directly tied to the Staggers Act mean that most rail shippers are far better off today than they were in 1980, not because of mergers per se, but because of the freedoms provided by the Staggers Act.

I would like to close with some thoughts on KCS' role in the changing railroad environment. Since I joined the railroad in 1995, I have seen seven (7) rail mergers. While we have rededicated our efforts towards being attentive to our shipper needs, been proactive in identifying new markets for our on-line shippers, and worked diligently with our connecting carriers to reduce barriers to long distance hauls, it is becoming increasingly difficult to survive independently in a consolidating industry. Fortunately, our North-South main line offers quality service between the Midwest and Mexico. Our two primary East-West routes, Meridian to Dallas and Kansas City to East St. Louis, respectively, function as strategic rail arteries, facilitating the movement of overhead traffic between eastern and western railroads by avoiding congestion at the major metropolitan cities of New Orleans and St. Louis, respectively. In addition, our marketing alliances with CN-IC, Norfolk Southern and the I&M Rail Link (IMRL) offer shippers options in choosing routes and carriers that enhance rail competition. While we are positioning ourselves to continue to serve our customers as a viable alternative rail entity for many years to come, it is becoming increasingly difficult to do so in a consolidating environment.

The 3,000 employees of KCS and Gateway Western, its 100% owned subsidiary, together with our partner railroads, Tex-Mex and TFM, are rightfully proud of their recent accomplishments and of their efforts to position these railroads as part of the first NAFTA Railway. But we are also pragmatic. If in fact the Surface Transportation Board approves future mergers that will move the railroad industry towards a two-carrier North American system, KCS will undoubtedly cast its fortunes with one of the two resulting carriers. The best interests of our shippers, our shareholders, and our employees would demand nothing less. If, however, the public interest is to be served through preservation of alternatives for rail shippers, we believe that KCS can play an important role as an alternative to the larger rail networks in some markets, and as a highly efficient connector of those networks in other markets.

Without a change in rail policy, I am forced to forecast KCS' ultimate inclusion in one of two remaining railroad systems simply because I cannot see KCS surviving as an independent regional, even with our investment in Mexico, if we are faced with two large transcontinental rail systems having expansive market coverage and unassailable market power. Those large systems will have no incentive to partner with KCS in routes and service because they will have their own routes. Let me use as an example the partnership KCS entered into through its Marketing Alliance with CN and IC in 1998. We considered that, through the new Alliance routes, we could effectively compete against the single line routings of BNSF and UP. The recently announced BNSF/CN/IC combination threatens the future existence of the Alliance. Although CN continues to assure KCS that it will honor the Alliance Agreement, we know that the Alliance route will be in direct competition with the new CN/BNSF route. In fact, recent promotional materials distributed to the shipping public by BNSF and CN in support of their proposed combination include a map of North America showing the new combination's single line capabilities between Canada and Mexico and between the Midwest and Mexico. CN's promises to abide by the terms of the CN/IC/KCS Marketing Alliance are tainted in light of such promotional statements. The Marketing Alliance amongst CN/IC/KCS clearly established a major third option for rail shippers moving traffic between Canada and Mexico, and between the Midwest and Southwest and to points in between. Without some guarantees that traffic will flow via the Alliance should BN/CN be approved, we can expect to see that option virtually dry up.

Additionally, KCS' role as an effective competitor would be undermined by re-regulation as much or more than it would by further mergers of its Class I competitors. Such practices as open reciprocal switching and the implementation of the "bottleneck" decision would leave regional railroads at the mercy of the large Class I railroads. Those larger Class I's will reach into the regional railroads' markets and, by means of their much broader market coverage, take traffic from the regionals to such an extent as to drive them out of existence. Short lines might survive in areas which the Class I's do not consider worth serving. But a national rail system consisting of but two Class I railroads would spell the demise of the regionals, leaving KCS no choice but to become a part of one of those two remaining Class I systems.

Once again, on behalf of KCS, I wish to commend the Board for the wisdom and foresight that it has shown in opening this proceeding. Your ultimate decisions in the BN/CN proposed merger will determine the future of the railroad industry.

Thank you.